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No. 91-375

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1991

JIM C. PLEDGER, DIRECTOR OF THE ARKANSAS DEPARTMENT OF FINANCE AND ADMINISTRATION, TIM LEATHERS, COMMISSIONER OF REVENUES, AND JIMMIE LOU FISHER, TREASURER OF THE STATE OF ARKANSAS.....*Petitioners*

VS.

STANLEY BOSNICK AND WILLA S. LINDSEY, GEORGE E. STEWART, DON LANE, JOHN SANDFORT, WILLIAM DAWSON BARLOW AND HANK GAJDA, ON BEHALF OF THEMSELVES AND ALL OTHER SIMILARLY SITUATED TAXPAYERS.....*Respondents*

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF ARKANSAS

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TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES:

STATUTORY PROVISIONS:

REASONS FOR DENYING THE PETITION

I. NO SUBSTANTIAL FEDERAL QUESTION IS PRESENTED UNDER *DAVIS* WHICH MERITS REVIEW ON WRIT OF CERTIORARI

A. The decision of the Arkansas Supreme Court on class certification issues does not present a federal question.

Petitioners presented to the Arkansas Supreme Court the issue of whether the trial court "erred in including within the certified class military retirees and retirees from other states' governmental agencies." *Pledger v. Bosnick*, 306 Ark. 45, 51, 811 S.W.2d 286 (1990). The Arkansas Supreme Court noted that "[t]he class certification order ... was an appealable order pursuant to Arkansas Rule of Appellate Procedure 2(a)(9)." *Id.* at 49. As such, that order should have been appealed at the time it was entered, but Petitioners failed to do so.[1] However, the Arkansas Supreme Court concluded that regardless of "whether the appellants failed to appeal that order in a timely manner, [the issue of timeliness] is moot" because the court found no error in the class certification. *Id.* This Court should not consider the issue raised in Section I of the Petition for Writ of Certiorari [hereinafter "Petition"] because it represents an improper attempt to transform a state law issue of class certification into a federal question.

B. No substantial federal question is presented by this case because application of the *Davis* test in Arkansas turns upon principles of state law.

After reviewing the history of intergovernmental tax immunity and 4 U.S.C. § 111, this Court reiterated in *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803 (1989) "[t]he imposition of a heavier tax burden on [those who deal with one sovereign] than is imposed on [those who deal with the other] must be justified by

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[1] Rule 4(a) of the Arkansas Rules of Appellate Procedure provides in relevant part: "Except as otherwise provided in subsequent sections of this rule, a notice of appeal shall be filed within thirty (30) days from the entry of the judgment, decree or order appealed from."

significant differences between the two classes." *Id.* at 815-16 (quoting *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. 376, 383 (1960)). The Court further noted that "[i]n determining whether this standard of justification has been met, it is inappropriate to rely solely on the mode of analysis developed in ... equal protection cases ... [because] where problems of intergovernmental tax immunity are involved 'the Government's interests must be weighed in the balance.' ... Instead, **the relevant inquiry is whether the inconsistent tax treatment is directly related to and justified by 'significant differences between the two classes.'**" *Davis*, 489 U.S. at 816 (emphasis added) (quoting *Phillips Chemical*, 361 U.S. at 383-85).

Military retirees and retirees of the State of Arkansas and its political subdivisions are similarly situated in that each belongs to the class of retired public officers or employees who leave active government service and receive retirement benefits based upon years of past service and rank or level of compensation obtained.[2] Since military retirees and retired state employees are similarly situated, then under applicable principles of intergovernmental tax immunity and 4 U.S.C. § 111, they "presumably should be taxed alike," *Phillips Chemical Co.*, 361 U.S. at 381, unless differential taxation is "directly related to **and** justified by significant differences between the two classes." *Davis*, 489 U.S. at 816 (citation omitted and

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[2] "Members of the Armed Forces who serve for a specified period, generally at least 20 years, may retire with a pension. 10 U.S.C. § 3911 *et seq.* (1982 ed. and Supp. V) (Army); § 6321 *et seq.* (Navy and Marine Corps.); § 8911 *et seq.* (Air Force)." *Mansell v. Mansell*, 490 U.S. 581 (1989). "The amount of retirement pay a veteran is eligible to receive is calculated according to the number of years served and the rank achieved. 10 U.S.C. §§ 3926 and 3991 (Army); §§ 6325-6327 (Navy and Marine Corps); § 8929 (Air Force)." *Mansell*, 490 U.S. at 583. *See also McCarty v. McCarty*, 453 U.S. 210, 214 (1981).

By comparison, members of the Arkansas Public Employees' Retirement System may retire after 30 years of service, regardless of age, or at age 60 after completing 20 years of service, or at age 65 after completing 10 years of service. Ark. Code Ann. § 24-4-508(a) (1987). The amount of retirement income a member of the Arkansas Public Employees' Retirement System receives is calculated according to the number of years of service and his or her average compensation. Ark. Code Ann. § 24-4-601(a) (1987).

emphasis added). Each of the two prongs of the *Davis* test must be satisfied before a discriminatory tax scheme can overcome the presumption of equal treatment recognized in *Phillips*.

The "direct relationship" requirement is not satisfied unless differential treatment is actually "based on" alleged differences between the two classes. *Phillips Chemical*, 361 U.S. at 384; *Davis*, 489 U.S. at 816. Like the offensive Michigan tax scheme struck down in *Davis*, Arkansas' tax exemptions discriminate solely based upon the source of payment.[3] No other distinguishing factor is set forth in Arkansas' tax exemption statute. No statute or legislative history establishes that the Arkansas legislature intended to single out military retired pay for discrimination because of any actual or perceived differences from other forms of retirement income. To the contrary, except for the income tax exemption favoring retired state government employees, the Arkansas legislature has historically treated all forms of retirement income, including military retired pay and civil service retirement, in the

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[3] The Arkansas statute involved here stated in relevant part:

> (a) Except as provided by subsections (b) and (c) of this section, the first six thousand dollars ($6,000) of retirement or disability benefits received after December 31, 1984, by any resident of this state from public or private employment-related retirement systems, plans, or programs, regardless of the method of funding for such systems, plans, or programs, shall be exempt from the state income tax.
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> (b) All retirement benefits, other than disability benefits, received by any resident of this state shall be exempt from the state income tax if: (1) The recipient is entitled to receive the benefits on or before December 31, 1989; and (2) The benefits are received from the Arkansas Public Employees Retirement System, The Arkansas Teacher's Retirement system, the Arkansas State Police retirement System, or the Arkansas State Highway Employees Retirement System, or any other retirement system, the benefits of which were entirely exempt from the state income tax immediately prior to the adoption of this section.

Ark. Code Ann. § 26-51-307(a) and (b).

same manner.[4] The complete absence of any evidence that the Arkansas legislature intended to or did discriminate against military retirees for any reason other than the source of the payment should end the inquiry. Otherwise, under Petitioners' approach of drawing distinctions not made by the legislature, States could essentially invoke and apply a rational basis test under the rubric of *Davis* despite the absence of any statutory authority or legislative history to support the alleged basis for the inconsistent tax treatment, a proposition this Court has rejected. *See Davis*, 489 U.S. at 816; *Phillips*, 361 U.S. at 385.

Nonetheless, Petitioners have asserted that the inconsistent tax treatment is based upon "the differing nature" of military retired pay rather than the source of compensation. Relying upon federal cases that characterized military retired pay for purposes of various federal statutes which have nothing to do with taxation or intergovernmental immunity, Petitioners assert that "military retirement pay is actually not a pension or deferred compensation, but constitutes reduced pay for reduced service." Petition at 8.[5] However, the Arkansas Supreme Court rejected this argument and held that military retired pay is deferred compensation for Arkansas income tax purposes. *Pledger v. Bosnick*, 306 Ark. 45, 53, 811 S.W.2d 286 (1991).[6] Since military retired pay is deferred

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[4] It is also interesting to note that after *Davis* the Arkansas legislature repealed the exemption that had favored retired state employees and still made no attempt to draw a distinction between military retired pay and other forms of retirement income. Thus, Arkansas continues to treat military retired pay the same as all other forms of retirement income.

[5] Petitioners' assertion that military retired pay is not a pension or deferred compensation conflicts with other portions of their Petition which refer to military retired pay as a "pension" that is "earned" during the years a member of the armed forces serves on active duty. Petition at 12.

[6] Arkansas has legislatively and judicially treated military retired pay as a pension or deferred compensation for state income tax purposes and for domestic property purposes. For state income tax purposes the Arkansas legislature has incorporated by reference the Internal Revenue Code provisions regarding deductions for IRA contributions. Ark. Code Ann. § 26-51-414 (Cont. next page)

compensation under Arkansas law, no direct relationship exists between the discriminatory taxation of military retired pay and the difference asserted by Petitioners. This alleged difference is simply not recognized under applicable state law.[7]

Essentially, Petitioners are requesting this Court to disregard Arkansas' characterization and treatment of military retired pay as a form of deferred compensation for state income tax purposes and determine as a matter of federal law that military retired pay is "current compensation for reduced services". While the ultimate issue under *Davis* is a matter of federal law, its resolution turns initially upon subsidiary issues of state law which were resolved by the Arkansas Supreme Court in favor of the Respondents. Since the Arkansas Supreme Court has held that military retired pay is properly characterized and taxed under state law as deferred compensation rather than current compensation, Petitioners actually seek a re-examination of this settled question of state law, an inappropriate basis for *certiorari*.[8]

(Supp. 1991). The Internal Revenue Service has treated military retired pay as a pension or deferred compensation for purposes of applying limitations on IRA deductions. The Arkansas Supreme Court has treated military retired pay as a pension that may be divided as marital property in divorce proceedings. *See Young v. Young*, 288 Ark. 33, 701 S.W.2d 369 (1986); *Askins v. Askins*, 288 Ark. 333, 704 S.W.2d 632 (1986); *Womack v. Womack*, 16 Ark. App. 108, 697 S.W.2d 930 (1985).

[7] In other *Davis* related cases, the highest appellate courts of two other states have refused to distinguish military retired pay from civil service retirement benefits. *See Kuhn v. State of Colorado*, No. 90SA299, 90SA300, slip op. (Colo. Sept. 16, 1991) (WESTLAW, 1991 WL 179971); *Hackman v. Director of Revenue*, 771 S.W.2d 77 (Mo. 1989) (en banc), *cert. denied* 110 S.Ct. 718 (January 8, 1990).

[8] Federal law should not preempt state law in situations such as this, where state law has consistently characterized military retired pay as deferred compensation for state tax and domestic property matters and that characterization does not violate federal law. *See Hisquierdo v. Hisquierdo*, 439 U.S. 572, 581 (1974); *United States v. Yazell*, 382 U.S. 341, 352 (1966).

C. **Arkansas' exemption statute is overbroad as was the Michigan statute in *Davis*; therefore, it fails the direct relationship requirement.**

In addition to their argument that military retired pay is current compensation, Petitioners have asserted that the discriminatory tax treatment of military retired pay is justified by such factors as: (1) members of the Armed Forces may retire at relatively young ages after completing 20 years of active military duty, (2) some military retirees may be recalled to active duty, and (3) the Arkansas Income Tax Act affords favorable treatment to military personnel while serving on active duty. Even if Petitioners are permitted to speculate on possible reasons why the Arkansas legislature could have discriminated against military retirees, and assuming further that the Arkansas legislature actually chose to discriminate because of the existence of such differences, the blanket discrimination which Arkansas has imposed against all military retirees is overbroad and therefore is not directly related to any of the differences asserted by Petitioners.

The reasoning applied by the Court in *Davis* is directly on point. There the Court rejected Michigan's arguments that federal retirement benefits could be subjected to inconsistent tax treatment because they were significantly more munificent than State and local retirement benefits "in terms of vesting requirements, rate of accrual, and computation of benefit amounts." 489 U.S. at 816. In rejecting this argument, the Court concluded that Michigan's discriminatory statute was not directly related to such differences, reasoning in relevant part:

> A tax exemption truly intended to account for differences in retirement benefits would not discriminate on the basis of the source of those benefits, as Michigan's statute does; rather, it would discriminate on the basis of the amount of benefits received by individual retirees.

Id. at 817. Applying that reasoning here, if Arkansas' discriminatory tax exemption was truly intended to account for

differences in retirement ages, account for the fact that some military retirees may be recalled to active duty or account for the fact that some military retirees were afforded favorable income tax treatment while serving on active duty, it would not have discriminated on the basis of the source of benefits, as the Arkansas statute has done; rather, it would have discriminated on the basis of the age of individual retirees, on the basis of whether the individual retiree previously received the benefit of such favorable treatment while serving on active duty or on the basis of whether the individual retiree may be recalled to active duty. Arkansas' statute did none of these things.

Paraphrasing the *Davis* opinion's reference to federal civil service retirees: "While the average retired [military officer may be younger] than his state counterpart, there are undoubtedly many individual instances in which the opposite holds true." *Id.* Furthermore, while many military personnel have received and continue to receive the benefit of Arkansas' $6,000 exemption for active duty compensation, undoubtedly some military retirees moved to Arkansas after retiring from active military duty and have never received the benefit of Arkansas' exemption for active duty income.[9] Finally, while many military retirees are subject to being recalled to active duty, there are undoubtedly many who are not.[10]

Arkansas has discriminated against all military retirees regardless of their age, regardless of whether they benefited (or how much they benefited) from Arkansas' active duty exemption during

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[9] Military retirees who are subsequently employed in federal civil service may elect to apply their years of military service towards a civil service retirement plan. 5 C.F.R. § 831.301(a). The fact that Arkansas' statute draws no distinction between military retirees who have applied their years of military service to the civil service retirement plan further illustrates that the inconsistent tax treatment of military retirees is not directly related to the differences asserted by Petitioners.

[10] *See, e.g.*, 10 U.S.C.A. § 675 (Supp. 1991) (retired reserve officers and enlisted personnel may be recalled only "if qualified" for active duty). Arkansas' statute draws no distinction between those retirees who are subject to recall and those who are not.

the years they earned their pensions, and regardless of whether they are subject to being recalled to active duty. This type of blanket discrimination against all retired military is overbroad and therefore is not "directly related" to any of the differences asserted by Petitioners.

D. The discriminatory taxation of military retired pay is not "justified by significant differences."

The second prong of the analysis focuses on whether the discriminatory tax treatment of military retirees is "justified by significant differences between the two classes." *Davis*, 489 U.S. at 816 (quoting *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. at 383). Petitioners assert that military retired pay is significantly different from the retirement income paid to former State employees and civil service employees in that the latter is deferred compensation or a pension, while military retired pay is current compensation. Essentially, Petitioners equate military retired pay with the current compensation (*i.e.*, wages, salaries) that is paid to current employees of the State of Arkansas, current federal civil service employees and active duty members of the armed forces.

As support for their argument, Petitioners rely upon various federal cases that have treated military retired pay as "reduced pay for reduced services" for purposes of interpreting and applying certain federal statutes. However, none of those cases has characterized military retired pay as current compensation for income tax purposes or otherwise indicated that Congress intended for retired pay to be treated as such for that purpose. In fact, Congress has never referred to military retired pay as "reduced pay for reduced service." Rather, that phrase has been used by federal courts in cases that have interpreted and applied various federal statutes for non-tax purposes, but in no case has it been declared or even implied that such a characterization was intended to or would justify tax discrimination against the recipients of military retired pay.

Petitioners contend that this Court should hold that military retired pay **must in all cases** be deemed to be current pay for current (albeit reduced) work. Respondents submit, on the other hand, that compensation to military retirees does not **always** have to be **either** a pension **or** current pay. To the contrary, as this Court noted in *McCarty v. McCarty*, 453 U.S. 210 (1981), military retired pay has characteristics of **both** deferred compensation and current compensation. *Id.* at 223 n.16.

What matters in reaching a determination as to the appropriate characterization in a particular case is the **purpose** of the inquiry. Here, the purpose relates to the ability of a state to discriminate against employees of the federal government, hence the focus of the inquiry should be upon the similarities between the favored class (retirees from Arkansas governmental service) and the targets of the discriminatory treatment (military retirees). When this focus is kept in mind, the similarities between these two classes are overwhelming and the differences for the subject purpose are nothing more than afterthoughts and makeweights. The distinctions certainly are not of such a magnitude as to rise to the level of such "significant differences" as would justify discrimination against the military retirees, as required by *Davis*. This Court need not repaint this gray horse black or white. All it need do is recognize that there are insufficient differences between state and military retirees to justify discrimination against the latter.

A major factor to consider when deciding this issue is the manner in which Congress has treated military retired pay. Congress and the Internal Revenue Service ("IRS") have, for federal tax purposes, consistently treated military retired pay in the same manner as any other pension or deferred compensation. For example, in 1956 Congress amended the Social Security Act ["SSA"] and the Federal Insurance Contributions Act ["FICA"] to bring military personnel under the contributory system of social security in the United States. Pub. L. No. 84-881, 70 Stat. 870 (1956). *See* 42 U.S.C.A. §§ 409(d), 410(l) and (m) (Supp. 1991)

[hereinafter SSA]; 26 U.S.C.A. §§ 3121(m) and (n) (Supp. 1990) [hereinafter FICA].[11] One of the primary purposes of the Social Security system is to provide benefits upon retirement when employees no longer expect to receive significant amounts of compensation for their services.[12] Thus, Congress has funded the Social Security program through FICA taxes imposed on employers and employees based upon specified percentages of "the wages (as defined in section 3121(a)) received by [an individual] with respect to employment." 26 U.S.C.A. § 3101(a) (Supp. 1990). Congress has defined the term "wages" broadly to include "all remuneration for employment" unless otherwise excluded. 26 U.S.C.A. § 3121(a) (Supp. 1990).

In extending Social Security coverage to military personnel, Congress specified that "basic pay" for active duty service would be included in the term "wages" subject to FICA taxes, but did not include retired pay within the meaning of "wages" subject to FICA taxes. 26 U.S.C.A. § 3121(i)(2) (Supp. 1990). The significance of this is emphasized by the fact that Congress specifically included retired military in the definition of who is a "member of a uniformed service." 26 U.S.C.A. §§ 3121(m) and (n) (Supp. 1990).

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[11] The purpose of this legislation was to "cover military personnel into the contributory Social Security System, thereby supplementing military retirement and survivors benefits." S. Rep. No. 2380, 85th Cong., 2d Sess. 1, *reprinted in* 1956 U.S. Code Cong. & Admin. News 3976, 3977. For members of the federal military, "[c]ontributions and benefits [are the] same as civilian employment." House Select Comm. on Survivor Benefits, 84th Cong., 2d Sess., AN ANALYSIS OF PUBLIC LAW 881 (H.R. 7089) 5 (Comm. Print 1956). *See Survivor Benefit Act: Hearings on H. R. 7089 Before the Senate Comm. on Finance*, 84th Cong., 2d Sess. 60 (1956) (statement of Captain David L. Martineau) (regarding employee contributions, "military service personnel ... would be treated exactly the same as any other citizen who is now covered by social security.").

[12] Participants in the Social Security System become eligible to receive old age benefits at age 62; however, the amount of benefits they otherwise would be entitled to receive are reduced if the participant receives compensation "on account of work" in excess of specified levels. 42 U.S.C.S. § 403(b) (Supp. 1991).

If Congress had intended to treat military retired pay for tax purposes as current compensation for reduced services, as Petitioners assert, it would have included retired pay within the definition of "wages" and subjected retired pay to FICA taxes. To the contrary, Congress expressly recognized military retirees as "members of the uniformed services" but excluded their retired pay from the definition of "wages" subject to FICA tax. The reason military retired pay was not included in the term "wages" is that Congress does not consider it as wages for employment which should be taxed as current earnings or compensation. Thus, Congress has treated "basic pay" for active duty the same as all other forms of current compensation received by public and private sector employees that are subject to FICA taxes, while affording military retired pay the same tax treatment as all other retirement benefits that are paid to civilians including civil service retirement benefits, benefits paid by Arkansas' retirement systems, IRAs, SEPs and other types of qualified retirement plans. 26 U.S.C.A. §§ 3121(a)(5)(E) and (v)(3).

Petitioners' arguments are also in direct conflict with the fact that Congress and the IRS have treated military retired pay as a pension or deferred compensation for purposes of applying federal income tax provisions which limit the amount a taxpayer may claim as a deduction for contributions to an Individual Retirement Account ("IRA"). The amount which a taxpayer may contribute to an IRA and claim as a federal income tax deduction is limited to the lesser of $2,000 or *the amount of the taxpayer's compensation*. 26 U.S.C.A. § 219(a), (b) (Supp. 1991). The IRS has determined that government retirement benefits, including military retired pay, are not *compensation* within the meaning of the term as used by Congress in limiting IRA deductions, reasoning as follows:

> Section 1.219-1(c) of the Income Tax Regulations provides that the term 'compensation', for purposes of sections 219 and 220 of the Code, means wages, salaries, professional fees, or other amounts derived from or received from personal services actually rendered .... Congress has interpreted this regulation to mean that

> benefits received under a pension plan or other plan of deferred compensation is not compensation for purposes of sections 219 and 220 of the Code. See Staff of the Joint Committee on Taxation, 97th Cong. 2d Sess., General Explanation of the Economic Recovery Tax Act of 1981, (Comm. Print December 29, 1981), page 197, n.1.
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> This interpretation is consistent with the legislative intent behind the enactment of the tax law relating to IRAs. **The purpose of an IRA is to give employees or self-employed individuals the opportunity to set aside some of their earnings for retirement.** See S. Rep. No. 93-383, 93d Cong. 1st Sess. 131 (1973), 1974-3 C.B. Supp. 210. **To base an IRA deduction upon contributions made with retirement pay would be inconsistent with this purpose.**

Priv. Ltr. Rul. 82-27-053 (Apr. 9, 1982) (emphasis added). M. Weinstein, MERTENS LAW OF FEDERAL INCOME TAXATION § 25C.12 at 58 (1988). The IRS has specifically determined in other letter rulings that the military retirement system is a **retirement plan** sponsored by government for the benefit of its employees. *See* Priv. Ltr. Rul. 87-25-094 (Mar. 30, 1987); Priv. Ltr. Rul. 80-07-048 (Nov. 21, 1979).

Congress has endorsed the IRS's reasoning by amending section 219(f)(1) to specifically exclude from the term "compensation" "any amount received as a pension or annuity [or] as deferred compensation." Technical Corrections Act of 1982, Pub. L. No. 97-448, § 103, 96 Stat 2365, 2375 (1983). Thus, Congress and the IRS have treated military retired pay as a pension or deferred compensation under the Internal Revenue Code for purposes of applying the limitations on IRA deductions. If Congress had intended military retired pay to be treated for tax purposes as "reduced compensation for reduced services," as Petitioners have asserted, then Congress would have included military retired pay in the meaning of "compensation" as used for calculating the amount which taxpayers may claim as an IRA deduction.

Considering the congressional treatment of military retired pay and the other similarities between military retirees and retired employees of the State of Arkansas both while in active government service and upon retirement, the following conclusions can be drawn:

1. Before retirement from active government service -- All such retirees received compensation for active service performed prior to retirement; all such retirees were equally subject to federal income taxation; all such retirees paid "employment taxes" on "wages" for employment under the Federal Insurance Contributions Act ("FICA," 26 U.S.C. § 3101 *et seq.*); all such retirees acquired legal interests in retirement pay capable of ownership as "property" and divisible as marital property upon dissolution of marriage; and all such retirees became eligible or qualified to receive retirement pay in accordance with years of service and highest position or rank attained.

2. Upon retirement from active service -- All such retirees left active government service; all such retirees acquired a "retired" status and received retirement or retired pay in accordance with their years of service and highest rank or position attained; all such retirees are prohibited from taking an IRA deduction under Internal Revenue Code § 219 and the Arkansas Income Tax Act as an offset against their retirement pay; all such retirees are exempt from paying "employment taxes" under FICA on retirement income since it does not qualify as "wages" for "employment" (*see* 26 U.S.C. § 3121(a)(5)); and all such retirees receive retirement income which is owned as property and divisible as marital property upon dissolution of marriage.

As the above demonstrates, even though military retired pay has characteristics of both deferred compensation and current compensation, the current compensation components of military retired pay do not amount to the type of "significant differences" that would "justify" discriminatory taxation of federal retirees in favor of retired state government employees. *Kuhn v. State of Colorado*, No. 90SA299, 90SA300, slip op. (Colo. Sept. 16, 1991) (WESTLAW, 1991 WL 179971). To paraphrase *Davis*: "It is

difficult to imagine that Congress consented to discriminatory taxation of the pensions of retired [members of the Armed Forces] while refusing to permit such taxation of [retired civil service] employees, and nothing in the statutory language or even in the legislative history [of 4 U.S.C. § 111] suggests this result." *Davis*, 489 U.S. at 810.[13]

In sum, under the principles of intergovernmental tax immunity, "a State may not single out those who deal with the Government, in one capacity or another, for a tax burden not imposed on others similarly situated." *Phillips*, 361 U.S. at 376. With respect to federal officers and employees, the doctrine is restated in 4 U.S.C. § 111, which prohibits discriminatory State taxation of "salaries, retirement benefits, and other forms of compensation ... on account of the source of the compensation." *Davis*, 489 U.S. at 810. Nothing in the doctrine or the statute differentiates between military and other federal employees. The nondiscrimination clause of 4 U.S.C. § 111 protects federal retirement benefits. "The danger that a State is engaging in impermissible discrimination against the Federal Government is greatest when the State acts to benefit itself and those in privity with it." *Davis*, 489 U.S. at 815 n.4. Thus, the State must "treat those who deal with the [Federal] Government as well as it treats those with whom it deals itself." *Phillips*, 361 U.S. at 385. The Arkansas Supreme Court correctly held that the Arkansas legislature has violated this cardinal rule.

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[13] Whatever the differences may be between military retired pay and other forms of public sector retirement income, they exist because Congress has created a military retirement system deemed necessary to our national defense. Consequently, any such differences result from the congressional exercise of constitutional power in furtherance of our national interests (U.S. Const. art. I, § 8, cls. 12, 13, 14 and 18), and do not qualify as a proper domestic concern of any state. Moreover, since Congress has not consented to discriminatory state taxation of military retired pay, such differential tax treatment clearly infringes upon and interferes with the military retirement system and, therefore, poses a threat to the attainment of its national objectives as recognized by this Court in *McCarty*, 453 U.S. at 232-35.

E. No substantial federal question is presented by the decision of the Arkansas Supreme Court holding that principles of intergovernmental tax immunity prohibit the State of Arkansas from discriminating against retired employees of other states, nor could such discrimination survive the equal protection challenge.

In *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871) this Court recognized that because States are independent sovereignties it must be implied that they are entitled to some type of immunity from taxation. Even though the broadest application of that decision was later limited, there still remains immunity which precludes discrimination. *Graves v. New York*, 306 U.S. 466 (1939). This immunity impliedly "arises from the constitutional structure and a concern for protecting state sovereignty." *South Carolina v. Baker*, 485 U.S. 505, 518 n.10 (1988).

The doctrine of "intergovernmental tax immunity is based on the need to protect **each sovereign's** governmental operations from undue interference by the other." *Davis v. Michigan Dept. of Treasury*, 489 U.S. at 814 (emphasis added) (citing *Graves*, 306 U.S. at 481, and *McCulloch v. Maryland*, 4 Wheat, at 435-436). The doctrine of intergovernmental tax immunity bars "those taxes that [are] imposed directly on one **sovereign** by the other or that discriminate ... against a **sovereign** or those with whom it dealt". *Davis*, 489 U.S. at 811 (emphasis added). "[T]he imposition of a heavier tax burden on those who deal with one **sovereign** than is imposed on those who deal with the other must be justified by significant differences between the two classes." *Davis*, 489 U.S. at 815-16 (citing *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. at 383) (emphasis added).

No substantial federal issue arises from the decision of the Arkansas Supreme Court to apply these principles of intergovernmental immunity to prohibit the State of Arkansas from discriminating against retired employees of another state.

Furthermore, even though the Arkansas Supreme Court did not

reach the issue, as this Court should not, the subject discrimination denied the retirees from other states Equal Protection under the Fourteenth Amendment since no **legitimate state purpose** would be promoted by allowing Arkansas to draw a distinction among government retirees based solely upon which government paid their retirement benefits. *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985); *WHYY v. Glassboro*, 393 U.S. 117 (1968); *Wheeling Steel Corp. v. Gladner*, 337 U.S. 562 (1949).

II. NO SUBSTANTIAL FEDERAL QUESTION IS PRESENTED BY THE DECISION OF THE ARKANSAS SUPREME COURT TO PROVIDE RETROACTIVE RELIEF

A. No federal issue arises when a state chooses, as Arkansas has done, to provide relief from unconstitutional tax burdens, even if that relief is greater than federal law would require.

The trial court ordered the State of Arkansas to pay refunds pursuant to Arkansas' Tax Procedures Act (Ark. Code Ann. § 26-18-507(a) (1987)) without expressly engaging in an analysis under the three-prong test set out in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971). On appeal to the Arkansas Supreme Court, Petitioners argued that the trial court erred by not applying a *Chevron* type of analysis to determine if *Davis* must be applied retroactively. Respondents contended that "regardless of the three *Chevron* factors" they were entitled to retroactive relief (*i.e.*, refunds) pursuant to the Arkansas Tax Procedures Act which provides for refunds of illegally exacted taxes and, since the Arkansas refund remedy complies with the mandate of *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 488 U.S. 954 (1990) to provide "meaningful backward looking relief," the state remedy should be applied without regard to retroactivity analysis. *Pledger v. Bosnick*, 306 Ark. 45, 55, 811 S.W.2d 286 (1991). The Arkansas Supreme Court concluded that, "[u]nder *either theory*, we hold that *Davis* ... must be applied retroactively." *Id.* Thus, the Arkansas Supreme Court affirmed the trial court's decision which ordered the state to pay refunds pursuant to Arkansas' tax refund

statute.[14]

"[F]ederal law sets certain minimum requirements that States must meet but may exceed in providing appropriate relief." *American Trucking Assns., Inc. v. Smith*, 110 S.Ct. 2323, 2331 (1990). "Although the Federal Constitution constrains the minimum remedy a State may provide ... it does not ordinarily limit the State's power to give a decision remedial effect greater than that which a federal court would provide." *Id.* at 2349 (Stevens, J., dissenting) (citations omitted). Thus, no federal issue arises when a state chooses, as Arkansas has done, to provide relief from an unconstitutional tax, even if that relief is greater than federal law would require.

B. Retroactivity is not an issue in statutory interpretation and application.

Davis construed and applied a federal statute, 4 U.S.C. § 111, originally enacted by Title I, Section 4 of the Public Salary Tax Act of 1939 (effective January 1, 1939). As thus construed, 4 U.S.C. § 111 has been "the supreme Law of the Land" since its effective date of January 1, 1939, and the import of *Davis* "is not to make a new law but only to hold that the law always meant what the court now says it means." *Fleming v. Fleming*, 264 U.S. 29, 31 (1924). As this Court in *Fleming* aptly recognized: "The court has power to construe a legislative act, but it has no power by change in construction to date its passage as a law from the time of the later decisions." *Id.* at 31-32 (1924). *Cf. Aloha Airline v. Director of Taxation of Hawaii*, 464 U.S. 7, 14 n.10 (1983).

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[14] Similarly, in other post-*Davis* related cases, the highest appellate courts of at least two other states have declined to engage in a *Chevron* analysis and have ordered tax refunds pursuant to state tax refund statutes reasoning that the refund rights granted under state refund law render such an analysis irrelevant to deciding a state law refund claim in state courts. *See Hackman v. Director of Revenue*, 771 S.W.2d 77 (Mo. 1989) (*en banc*), *cert. denied*, 110 S.Ct. 718 (1990) and *Kuhn v. State of Colorado*, No. 90SA299, 90SA300, slip op. (Colo. Sept. 16, 1991) (WESTLAW, 1991 WL 179971).

Under the *Fleming* principle there simply is no issue of retroactivity calling for a *Chevron* analysis. Arkansas' discriminatory tax scheme has always violated the 1939 federal statute, not from the date of the *Davis* decision but from the date of its adoption in 1971. There is, therefore, no occasion for consideration of retroactivity of *Davis*.

C. Any issue of retroactivity of *Davis* has been conclusively resolved.

Although there was no majority opinion for the Court in *James B. Beam Distilling Co. v. Georgia*, ___ U.S. ___, 111 S.Ct. 2439 (1991), six of the Justices agreed that a decision of the Court may not be applied retroactively in the case before it but only prospectively in other cases. That is, "when the Court has applied a rule of law to the litigants in one case, it must do so with respect to all others not barred by procedural requirements or res judicata." *Id.* at 2448.[15]

In *Davis*, the Court invalidated Michigan's discriminatory tax scheme as in effect during the tax years 1979 through 1984 and applied its decision to the litigants before it stating that "to the extent appellant has paid taxes pursuant to this invalid tax scheme, he is entitled to a refund," 109 S.Ct. at 1508-09 (citing *Iowa-Des Moines Bank v. Bennett*, 284 U.S. 239, 247 (1931)). Having accorded Paul Davis the benefit of the decision in *Davis*, that holding must be applied "to all others not barred by procedural

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[15] While the above quotation from Justice Souter's opinion, which Justice Stevens joined, does not purport to be the opinion of the Court, Respondents believe that it most succinctly states the minimum *common* opinion of the six Justices in the majority in *Beam*. *See id.* 111 S.Ct. at 2448 (White, J. concurring in the judgement) ("There [is] no precedent in civil cases applying a new rule to the parties in the case but not to others similarly situated"); *id.* at 2450 (Scalia, J., with whom Marshall and Blackmun JJ. joined, concurring in the judgement) ("I would find both 'selective prospectivity' and 'pure prospectivity' beyond our power"); *id.* at 2449 (Blackmun, J., with whom Marshall and Scalia, JJ. joined, concurring in the judgement) ("I conclude that prospectivity, whether 'selective' 'or pure' breaches our obligation to discharge our constitutional function.")

requirements or res judicata." *Beam*, 111 S.Ct. at 2448.

Petitioners assert that because Michigan conceded that a refund was an appropriate remedy in the event its statute was determined to be unconstitutional, this Court did not apply its decision in *Davis* to the parties before it, but "simply allowed state law to govern the issue" of retroactivity. Petition at 22. To the contrary, Michigan's concession that a refund was the proper choice of remedy for its unconstitutional tax is irrelevant to the federal choice of law question of whether *Davis* and 4 U.S.C. § 111 were, in the first instance, effective to invalidate Michigan's tax scheme as in effect during the tax years 1979 through 1984. This concession would have been of no consequence unless the Court as a matter of choice of law applied its ruling to the litigants before it.

The substantive question of the constitutionality of a tax and the remedial question arising upon its invalidation are two distinct issues. The remedial question would not have arisen in *Davis* unless the Court had applied its decision invalidating Michigan's taxes to the parties before it. All Michigan's concession did was agree to the requested remedy if it lost on the merits.[16] In fact, the plurality in *Beam* cited *Davis* as support for the proposition that, when the Court remands a case for consideration of remedial issues without reserving the question of retroactivity, it "necessarily implies that the precedential question has been settled to the effect that the rule of law will apply to the parties before the Court." *Beam*, 111 S.Ct. at 2445-2446. Accordingly, *Davis* is properly read as having applied the rule of law announced therein to the parties in that case.

Once having retroactively applied the rule of law announced in *Davis*, it is irrelevant how the Court arrived at its determination

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[16] Michigan did not merely concede that a refund was the appropriate remedy, it actually argued that, *if* its tax law was declared unconstitutional, a refund would be the proper *choice of remedy* rather than striking the exemption that favored state retirees and imposing a tax on them. *See* Brief for State of Michigan at 61-63, 82-83, *Davis v. Michigan*, 489 U.S. 802 (1989) (No. 87-1020).

to do so or even if it were correct in having done so. As the plurality made clear in *Beam*, whether the prospectivity issue was actually litigated and decided by the Court in *Davis* is "unnecessary" to the issue of whether *Davis* must be applied retroactively here. *Id.* at 2445 n.2. Justice White similarly noted that how or why the Court ended up applying its rule to the parties before it was irrelevant, stating: "even if ... the Court was quite wrong in doing so, that is water over the dam, irretrievably." *Id.* at 2248.

As the plurality stated in *Beam*, if the Court "did not reserve the question of whether its holding should be applied to the parties before it ... [the decision] is properly understood to have followed the normal rule of retroactive application in civil cases." *Id.* at 2445. Because there is a presumption of retroactivity, and because the *Davis* decision applied its ruling to the parties before it without purporting to reserve that question, the issue of the retroactivity of *Davis* has been conclusively resolved.[17]

D. Even if an analysis under *Chevron Oil* is appropriate, the Arkansas Supreme Court correctly held that *Davis* must be applied retroactively.

All three of the *Chevron* factors must be satisfied before the presumption of retroactivity can be overcome and *Davis* can be applied prospectively. Here, not even one of the *Chevron* factors which would justify departure from the rule of full retroactivity is satisfied.

"The first prong of the *Chevron Oil* test requires that 'the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression, whose resolution was not clearly foreshadowed.'"

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[17] Thus, this Court vacated and remanded the decisions in *Harper v. Virginia Dept. of Taxation*, 401 S.E.2d 868, *vacated*, ___ U.S. ___, 111 S.Ct. 2883 (1991), and *Bass v. State of South Carolina*, 395 S.E.2d 171 (1990), *vacated*, ___ U.S. ___, 111 S.Ct. 2881 (1991) rendering Petitioners' reliance thereon misplaced.

Ashland Oil, Inc. v. Caryl, ___ U.S. ___, 110 S.Ct. 3202, 3204 (1990) (per curiam) (citation omitted) (quoting *Chevron*, 404 U.S. at 106-07). This is a threshold test which, if not satisfied, requires that a decision be applied retroactively. *Id.* at 3205.

Davis did not overrule past precedent of this Court nor did it decide an issue of first impression whose resolution was not clearly foreshadowed. To the contrary, *Davis* is replete with analysis and express language which unequivocally demonstrates that the law in this area has been clearly established and that the result in *Davis* was clearly foreshadowed. Accordingly, the threshold prong of the *Chevron* test has not been satisfied.

In resolving the question of statutory construction in *Davis* the Court stated:

> We have **no difficulty** concluding that civil service retirement benefits are deferred compensation for past years of service rendered to the Government .... **[T]he overall meaning of § 111 is unmistakable**: it waives whatever immunity past and present federal employees would otherwise enjoy from state taxation of salaries, retirement benefits and other forms of compensation paid on account of their employment with the Federal Government, except to the extent that such taxation discriminates on account of the source of compensation .... **Any other interpretation** of the nondiscrimination clause [in 4 U.S.C. § 111] **would be implausible at best**.

Davis, 489 U.S. at 808-10 (emphasis added).

In rejecting Michigan's argument "that the purpose of the [intergovernmental tax] immunity doctrine is to protect governments and not private entities or individuals" the *Davis* Court stated, **"Indeed, all precedent is to the contrary ... The State offers no reasons for departing from this settled rule, and we decline to do so."** *Id.* at 814-15 (emphasis added). The Court listed no fewer than five of its tax decisions dating back to 1842 in support of the

proposition that federal retirees may not be taxed discriminatorily and concluded its discussion of its precedents by noting:

> **As we observed in *Phillips Chemical Co.*,** 'it does not seem too much to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself.'

Id. at 815 n.4 (emphasis added) (quoting *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. 376 (1960)).[18]

Davis "was not **revolutionary** ... nor [did it] decide a **wholly new issue** of first impression." *Ashland Oil, Inc. v. Caryl*, ___ U.S. ___, 110 S.Ct. 3202, 3205 (1990) (emphasis added). *See also National Mines Corporation v. Caryl*, ___ U.S. ___, 110 S.Ct. 3205 (1990). Indeed, *Davis* was, if anything, less "revolutionary" than this Court's decision in *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984) in which this Court unanimously applied retroactively last term in *Ashland Oil* and *National Mines*. Since *Davis* did not establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed, it does not clear the threshold hurdle of *Chevron* and must be applied retroactively.

The second prong of the *Chevron* test focuses on the purpose and effect of the constitutional rule in question and "whether retrospective operation will further or retard [the policies underlying] the rule in question." *Chevron*, 404 U.S. at 107. Here, those policies are to prevent "[t]he imposition of a heavier tax burden on [those who deal with one sovereign] than is imposed on [those who deal with the other]." *Davis*, 489 U.S. at 815-16. In the instant case, applying *Davis* retroactively will promote the doctrine of intergovernmental tax immunity and 4 U.S.C. § 111 in

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[18] *Phillips Chemical* was a 1960 decision that was decided eleven years prior to Arkansas' enactment of the first discriminatory exemption favoring state government employees over federal retirees.

two significant ways: (1) redressing the United States' and Respondents' federal statutory and constitutional injuries and (2) deterring future violations.

Relying upon *American Trucking Assns., Inc. v. Smith*, 483 U.S. 1014 (1990), Petitioners assert that "the purpose of [the doctrine of] intergovernmental tax immunity is not to prevent legitimate state taxation ..." and that "retroactive application of *Davis* would not further operation of the doctrine." Petition at 19. However, the factors that led the plurality in *Smith* to conclude that retroactive application of *American Trucking Assns., Inc. v. Scheiner*, 483 U.S. 266 (1987) would not deter future constitutional violations are not applicable here. In *Smith*, the plurality applied the following reasoning under the second prong of the *Chevron* test:

> *Scheiner* established a 'new principle of law' by **overruling** those aspects of the *Aero Mayflower* cases on which the State of Arkansas relied in enacting and assessing the HUE tax ... [T]he HUE tax was entirely consistent with the *Aero Mayflower* line of cases and it is not the purpose of the Commerce Clause to prevent legitimate state taxation of interstate commerce.

110 S.Ct. at 2332 (emphasis added).

Similarly the dissent in *Beam* applied the following reasoning to conclude that retroactive application of the Court's decision in *Bacchus* would not deter future constitutional violations:

> [*Bacchus*] came **out of the blue** ... **overruled** ... [prior precedents of this Court] and created a **new rule** .... Before our decision in *Bacchus*, the State of Georgia was fully justified in believing that the tax at issue in this case did not violate the Commerce Clause. Indeed, before *Bacchus* it did not violate the Commerce Clause. The imposition of liability **in hindsight** against a State that, acting reasonably would do the same thing again, will

> prevent no unconstitutionality .... Precisely because *Bacchus* was so **unprecedented**, the equities weigh heavily against retroactive application of the rule announced in that case.

Beam, 111 S.Ct. at 2455 (O'Connor, J., dissenting) (emphasis added).

Unlike *Scheiner* and (arguably) *Bacchus*, *Davis* did not overrule prior precedents of this Court; therefore, the reasoning that led the plurality in *Smith* and the dissent in *Beam* to conclude that retroactivity would not deter future constitutional violations is not applicable here.

Under Petitioners' approach to the second prong of the *Chevron* test, prospectivity would be the norm rather than the infrequent exception. In that situation, any impulse state legislators have to enact constitutionally dubious taxes would be reinforced by the knowledge that such preferences would be not only politically advantageous but economically cost-free. Accordingly, retroactive application of *Davis* will promote the federal constitutional interest in preventing future violations of the doctrine of intergovernmental immunity by placing state legislators at pains to avoid the evils forbidden by the doctrine of intergovernmental immunity and 4 U.S.C. § 111. *See Nippert v. City of Richmond*, 327 U.S. 416 (1946).

Retroactive application of *Davis* will also promote the purposes of the doctrine and 4 U.S.C. § 111 by enabling the federal government to recover, in part, the revenues it has lost in past years as the result of the discriminatory practices found unconstitutional in *Davis*. *See Davis*, 489 U.S. at 815 n.4. Unlawful state taxes have been paid and deducted under 26 U.S.C. § 164 on federal returns in past years by numerous federal retirees directly reducing federal income tax collections. The refunds to which these citizens are entitled are subject to federal income taxation under 26 U.S.C. § 111 and will now enable the federal government to recover, in part, those lost federal revenues.

Contrary to Petitioners' assertion, the fact that the Arkansas legislature has repealed the exemptions that had favored retired state employees has no bearing on the second prong issue of whether retroactive application of *Davis* would further or retard the purposes of the doctrine. The Arkansas legislature merely made a choice between two prospective remedies for the future: "withdrawal of benefits from the favored class" or "extension of benefits to the excluded class." *Davis*, 489 U.S. at 818. The action taken by the legislature in making the choice between prospective remedies did nothing to promote the constitutional interests in remedying past discrimination and deterring future violations of the doctrine of intergovernmental tax immunity.

When it amended the law in 1989, the Arkansas legislature chose to increase state revenues by capping the exemption for state retirees, thus improving the financial condition of the state, but it did nothing to remedy the past offense. Moreover, even the action taken was not solely because *Davis* was decided, but in fact it only occurred *after* the trial court in *this* case invalidated the Arkansas law and ordered refunds. Only retroactive application of *Davis* will further the purpose of the doctrine of intergovernmental tax immunity by discouraging its violation in the future. Otherwise, legislatures can discriminate at will and simply change the law prospectively when challenged, reaping and retaining the interim benefits of their unlawful legislation.

The third prong of the *Chevron* test focuses on the issue of whether retroactive application of *Davis* would produce "substantial inequitable results." *Chevron*, 404 U.S. at 107. The State of Arkansas did not rely on precedents of this Court in adopting its discriminatory tax scheme. **"Indeed, all precedent is to the contrary."** *Davis*, 489 U.S. at 814 (emphasis added). Unlike *Scheiner* and (arguably) *Bacchus*, *Davis* did not upset settled expectations emanating from previous decisions of this Court; thus, the reliance interests which persuaded the plurality in *Smith* and the dissent in *Beam* to conclude that it would be inequitable to apply *Scheiner* and *Bacchus* retroactively simply are not present here.

These circumstances pose a paradigmatic question: who should bear the burden associated with enactment of an unconstitutional tax, the group of taxpayers whose rights have been violated or all taxpayers of the state that imposed the tax? The citizens of Arkansas and other states have for many years received the benefit of increased government services and/or lower taxes as the result of the unconstitutional taxes.[19] Thus, it is not inequitable to require the citizens of such states to share the burden of remedying the constitutional violations that occurred in years which are not yet barred by the statute of limitations. Applying *Davis* retroactively will fairly "allocate any resulting financial loss to the inevitable costs of government borne by all the taxpayers [rather] than ... solely by those whose rights ... have been violated." *Owen v. City of Independence*, 445 U.S. 622, 655 (1980).

The Court reiterated in *McKesson v. Division of Alcoholic Beverages and Tobacco*, 488 U.S. 954 (1990) that states may limit their obligation to provide postdeprivation remedies through the use of statutes of limitations and by requiring payment under protest. *Id.* at 2250-55. The Arkansas legislature weighed the equities when it decided to provide taxpayers with the right to obtain tax refunds subject only to the requirement that they file a refund claim within the applicable statute of limitations period (normally three years). Ark. Code Ann. § 26-18-306(i). In doing so, the Arkansas legislature chose to waive the common law ability to require payment under protest as a prerequisite to obtaining a refund. Thus, there is nothing inequitable about requiring Arkansas and other similarly situated states to honor their commitments to provide taxpayers with postdeprivation remedies that were assured them at the time taxes were collected. It is not for the Court to second guess a decision of the Arkansas legislature to refund taxes even if the Constitution otherwise might not require it.

The fact that Arkansas' discriminatory scheme has been in

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[19] Arkansas has discriminated in favor of retired employees of the State of Arkansas since 1971.

effect for many years does not give rise to a reliance interest under *Chevron*. *See Ashland Oil v. Caryl*, 110 S.Ct. at 3205 n.*. Furthermore, the sheer number of states violating a Congressional or constitutional mandate has never been a proper justification for unlawful state enactments. *See South Carolina v. Baker*, 485 U.S. 505, 515 (1988). As the Arkansas Supreme Court observed below, retroactive application of *Davis* does not cause an inequitable result because that case was decided; rather there will be a burden imposed upon one side or the other because the Arkansas legislature passed an unconstitutional act. Since one side or the other must suffer, there is not an *avoidable* inequitable result; hence, the third *Chevron* prong is not met.

CONCLUSION

Wherefore, Respondents pray that Petitioners' Petition for Writ of Certiorari be denied.

Respectfully submitted,

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